

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Assembly Bill 1122

Assembly Member Corbett (As amended 4/3/02)

Position:

Support

Proponents:

SACRS

Opponents:

None known

SUMMARY

Assembly Bill 1122 Conforms California law to, among other things, the retirement plan provisions of the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

HISTORY

SB 657 (Scott), among other things, conforms California law to the retirement plan provisions of EGTRRA.

SB 1256 (Brulte), among other things, conforms California law to the retirement plan provisions of EGTRRA.

AB 131 (Corbett) allows members of government defined benefit plans who retired in 2002, but prior to the enactment of state tax conformity, to purchase service credit using rollover funds allowed under EGTRRA.

AB 1743 (Campbell), among other things, conforms California law to the retirement plan provisions of EGTRRA.

Chapter 803, Statutes of 2001, (SB 501—Senate PE&R), among other things, authorizes the Teachers' Retirement Board (Board) to establish terms and conditions that permit members of the California State Teachers' Retirement System (CalSTRS) to roll over funds from other traditional defined benefit/defined contribution retirement plans, Section 403(b) plans and Section 457 plans, and any IRAs, either to purchase permissive service credit or to redeposit previously withdrawn contributions to the Defined Benefit (DB) Program.

P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001, enacted a number of changes to federal law to enhance the portability of funds among different types of retirement plans, including 401(k), 403(b) and 457 plans, IRAs and 401(a) retirement plans. In addition, it increases the contribution limits to 403(b), 457 and 401(a) plans, and increases the annual allowance limit for defined benefit plans.

CURRENT PRACTICE

The State Teachers' Retirement Plan (Plan) is administered by CalSTRS in accordance with Section 401(a) of the Internal Revenue Code (IRC). The Plan consists of the DB Program, the Defined Benefit Supplement Program and the Cash Balance (CB) Benefit Program. In addition, CalSTRS offers members of the DB Program and participants in the CB Benefit Program a 403(b) deferred compensation retirement savings plan called the Voluntary Investment Program (VIP). The CalSTRS VIP is similar to 401(k) plans available to workers in private industry.

Changes to federal tax law under EGTRRA that became effective January 1, 2002 have a profound effect on administration of Plan assets and the retirement planning options available to CalSTRS members. However, differences between the federal IRC and the California Revenue and Taxation Code currently exist because current state law is based upon the former provisions of the IRC as it was in effect on January 1, 1998. California is among several states that have not changed tax laws to correspond with the more liberal federal law.

CalSTRS is required by the Education Code to administer the Plan in accordance with applicable provisions of the Internal Revenue Code and the state's Revenue and Taxation Code. Due to the conflict between state and federal pension laws, CalSTRS cannot permit its members to take advantage of the pension portability provisions and increased limits contained in EGTRRA. In addition, to do so would potentially jeopardize the tax-qualified status of the Plan.

CalSTRS benefits and services directly affected by the differences between federal and state tax law include:

Purchase of Service Credit

CalSTRS allows members of the DB Program to purchase additional service credit or repay previously refunded contributions, with the purchase fully paid prior to retirement. Under EGTRRA, direct trustee to trustee rollovers are allowed from 403(b), 401(k), 457 or IRA's to 401(a) defined benefit plans to purchase service credit for prior service. However, under state tax law, consistent with prior federal law, use of 403(b) and 457 funds to purchase service credit is not permitted and is treated as a taxable early distribution, subjecting members to a 2 ½ percent early distribution penalty assessed by the State.

Chapter 803, Statutes of 2001, effective January 1, 2002, made changes in the Education Code to allow CalSTRS to improve portability of retirement funds by deleting the former prohibition in using 403(b) funds to purchase service credit in the DB Program for out-of-state service. The bill also codifies the Board's existing authority in federal law to accept direct transfers of retirement funds from trustees of other retirement funds. The Board took action at its December 2001 meeting to begin implementation of the rollover provisions of EGTRRA in anticipation of state conformity, CalSTRS, however will not accept rollovers from 403(b) and 457 plans and non-conduit IRAs until state conformity is achieved. If CalSTRS were to accept rollovers using 403(b) or 457 funds not authorized under the state tax code, members would face potential penalties of 10 percent plus capital gains and personal income tax on the amount of the distribution that is allowable under federal law but not California law. In addition, the Plan

would face potential disqualification, subjecting the Plan and its members to additional income tax liability.

There are currently over 100 requests pending to transfer 403(b) funds to the DB Program for purposes of redepositing previously refunded contributions and purchasing additional service credit. CalSTRS is receiving about 10 additional requests per week to rollover 403(b) funds into the Plan.

Contribution Limits

EGTRRA increases the federal limit on contributions to 403(b) plans, such as the CalSTRS VIP, to \$11,000 in 2002, rising annually to \$15,000 in 2006. It also eliminates contribution limits imposed by a complex calculation called the Maximum Exclusion Allowance (MEA). Under current state law, 403(b) contribution limits remain subject to the MEA and are capped at the \$10,500 per year maximum imposed by the former federal law. Member contributions in excess of the lower state limits are taxable under California law.

This difference in contribution limits is confusing to CalSTRS members and difficult to administer. If California law does not conform to EGTRRA and is not retroactive to the effective date of the federal legislation, dual record keeping will need to be maintained in the VIP and similar plans for many years to establish and maintain the separate tax basis for California and federal tax reporting. Staff will be discussing with the VIP administrator various EGTRRA provisions that permit “catch-up” contributions and permit members to elect to treat elective deferrals as after-tax contributions. Until state tax conformity is achieved and the Board adopts these provisions, the CalSTRS VIP will remain unchanged.

EGTRRA also increases the limit on contributions to 401(a) defined benefit plans for the purchase of out-of-state and non-qualified service credit from \$35,000 per year to \$40,000 per year, whereas state limits remain at the lower level. While this limit affects few members of the DB Program, CalSTRS staff performs a complex calculation for each purchase that exceeds the contribution limit to determine its applicability. Until state conformity is achieved, CalSTRS will require members purchasing these types of service credit to adhere to the lower state contribution limit. This may force members making purchases of certain types of service credit near the end of their career to delay retirement because it will take longer to pay off the balance of their purchase at the lower levels.

Increase in Benefit and Contribution Limits

EGTRRA increases the annual limit on benefits payable from qualified public defined benefit plans such as the Plan from \$140,000 to \$160,000 for 2002. This amount will be annually adjusted for cost-of-living changes. It also increases from \$170,000 to \$200,000 the maximum annual compensation that is considered in determining contributions to CalSTRS and CalSTRS' retirement benefits. This also will be adjusted annually. Under current state law, benefits payable from a qualified public defined benefit plan and compensation subject to the benefit formula are restricted to the lower limits imposed by IRC under the prior federal law.

Although affecting a small number of members, using annual compensation limits at the lower state levels to calculate member contributions to, and benefits from, the DB Program will have a

significant impact on their current contribution levels and taxable incomes, as well as their eventual retirement incomes.

DISCUSSION

If the state does not conform to the changes in federal tax law made last year, CalSTRS members will be unable to take advantage of the EGTRRA provisions and will have significant long-term consequences on their retirement savings and the ability of the System to continue to provide benefits that members are otherwise able to receive.

AB 1122 amends California law to conform to new federal tax laws that:

- Allow rollovers among governmental 457 plans and 403(b) plans and other qualified plans and rollovers of IRAs to workplace retirement plans, allows rollovers of after-tax retirement plan contributions.
- Increase the limits on annual contributions to 401(k), 403(b) and 457 plans to \$11,000 in 2002; in 2003 and thereafter the limits are increased in \$1,000 annual increments until the limits reach \$15,000 in 2006, with indexing in \$500 increments thereafter.
- Allow individuals to make maximum contributions to both 401(k) and 457 plans simultaneously and repeals the MEA (a contribution limit) applicable to 403(b) plans.
- Increase defined benefit plan limits on contributions for certain service credit purchases to \$40,000 with indexing in \$1,000 increments.
- Increase the defined benefit allowance payable at retirement to \$160,000 annually.
- Increase from \$170,000 to \$200,000 the annual compensation limit used by defined benefit plans to determine contributions and benefits.

The bill also conforms state tax law to changes made in EGTRRA concerning the tax treatment of qualified tuition plans and education savings accounts, which are not discussed further in this analysis. The provisions of AB 1122 are retroactive to January 1, 2002 to conform to the effective date of the retirement plan provisions of EGTRRA.

According to the author: "it is incumbent upon California to enact a federal conformity measure as soon as possible. There are people all over the state who want to take advantage of 2001 federal retirement and education savings plan enhancements, yet who risk adverse state tax consequences if they do so. AB 1122 not only enacts needed federal conformity; it does so in a fiscally responsible manner."

FISCAL IMPACT

Benefit Program Costs – No significant costs to CalSTRS benefit programs

Administrative Costs – Costs would depend on the increased number of service credit purchase and redeposit requests, and would be paid by the Teachers' Retirement Fund.

BOARD POSITION

Support. Without corresponding changes to the California Revenue and Taxation Code, an enormous administrative burden will be placed on CalSTRS VIP administrators and other plan sponsors to develop and maintain dual accounting records for the plan to accommodate the differences between federal and state laws.

Members rely on their CalSTRS retirement allowance and individual retirement savings to ensure their income security during retirement. EGTRRA encourages teachers and other school employees to save additional money for retirement through contributions to a 403(b) contribution plan, and makes it easier for them to purchase service credit to boost their pension benefits. The inability of members to take advantage of the EGTRRA provisions will have significant long-term consequences on their retirement savings.